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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
	)	
Transport Rate Structure and Pricing Under Price Regulation	)	CC Docket No. 91-213
	)	

OPPOSITION OF BELL ATLANTIC TO PETITIONS FOR RECONSIDERATION OF PRICE CAP ORDER

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TABLE OF CONTENTS

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OPPOSITION OF BELL ATLANTIC[1]
TO PETITIONS FOR RECONSIDERATION
OF PRICE CAP ORDER

Summary and Introduction

Not satisfied with more than a billion and a half dollar price decrease, AT&T and Ad Hoc argue in their reconsideration petitions for even greater price cuts. Whether or not the existing price cuts can be justified,[2] however, there simply is no support for an argument that those price reductions were too ***small***.

On the contrary, AT&T and Ad Hoc repeatedly base their claims on arguments that were expressly rejected by the Commission in its order. In particular, they argue that jointly used

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1 The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; Bell Atlantic-West Virginia, Inc.; New York Telephone Company; and New England Telephone and Telegraph Company.

2 Bell Atlantic has appealed this order on the grounds that the price cuts were significantly larger than are supported by the record. That issue is not raised in the petitions here and is not addressed in this pleading.

facilities should be arbitrarily allocated among jurisdictions in order to calculate an interstate-only productivity result. But such an allocation cannot be done in an economically meaningful manner and the results of any such allocation cannot produce legitimate productivity calculations. Petitioners' other proposals are similarly without sound economic support. The Commission should reject both petitions.

I. The Commission Cannot Establish An Interstate-Only Measure of Total Factor Productivity

Despite the fact that the Commission expressly rejected their arguments for creating an interstate-only measure of productivity,[3] AT&T and Ad Hoc merely repeat the same arguments here.[4] Astonishingly, they do so without even attempting to address the evidence in the record that refuted their arguments.

The petitioners' claims are based on the unsupported presumption that because demand for interstate services grew faster than for intrastate services, productivity growth must also be greater for interstate services. There is simply no economic merit to this argument. Productivity studies must measure inputs as well as outputs. Because interstate and intrastate services rely on common facilities and labor, there is no way to isolate the inputs used to provide interstate services alone. As Dr. Melvyn Fuss explained, this means that there is no "economically meaningful way" to separate total costs into the costs of producing interstate services and the

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3 Fourth Report and Order at ¶ 110 (holding that there is "no basis in the record" to support an adjustment to the X factor "to account for any differences between interstate and total company productivity.")

4 Petition of AT&T Corp. for Partial Reconsideration at 3 (filed July 11, 1997) ("AT&T Petition"); Petition For Reconsideration on Behalf of Ad Hoc Telecommunication Users Committee ("Ad Hoc Petition"), attached Declaration of Patricia D. Kravtin at ¶ 20 ("Kravtin Declaration") (filed July 11, 1997).

costs of producing intrastate service.[5] As a result, there is no way to calculate a separate productivity growth rate for interstate services.

AT&T, however, tries to escape this fact by making the unsupported "assumption" that "inputs grow at the same rates for interstate access services as they do for other regulated (local and intrastate) services."[6] But AT&T cannot simply assume away the problem. And while AT&T claims that "no specific allocation of costs is required" given its assumption,[7] the assumption itself is "a particularly simplistic form of cost allocation which cannot be taken seriously as an economically meaningful allocation."[8]

Dr. Christensen explained the fallacy in AT&T's argument by using the analogy of a factory that produces red and blue paper clips. Except for the coloring, the two products use the exact same production process. By applying AT&T's assumption to his example, Dr. Christensen demonstrated that the assumption "led to the economically meaningless conclusion"

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5 Declaration of Melvyn Fuss, attached as Exhibit 2 to the Joint Reply Comments of Bell Atlantic and NYNEX, ¶ 6 (filed Feb. 14, 1997) ("Fuss Declaration").

6 AT&T Petition at 9.

7 AT&T Petition at 9.

8 Fuss Declaration at ¶ 8. AT&T also cites ***Rural Tel. Coalition v. FCC***, 838 F.2d 1307, 1314 (D.C. Cir. 1988) to support a secondary argument that even if its allocation is not "perfect," it is at least a "reasonable measure." AT&T Petition at 11. But AT&T's arguments fail even such a modest standard. The Court in ***Rural Tel. Coalition*** reaffirmed that when a regulator is ***required*** to separate costs among jurisdictions even when "there is no purely economic method of allocation," it may rely on "noneconomic values." This has no applicability here, where no allocation is required, and even AT&T agrees that the X factor calculation must have an economic basis. Because AT&T's methodology has no economic basis, it cannot be considered a "reasonable measure" and must be rejected.

that the "productivity growth of one color paper clip was different from the productivity growth of the other color."[9]

AT&T also points to an instance where, at the start of price cap regulation, the Commission attempted to differentiate interstate productivity.[10] Again, its argument is misplaced. The model used there was based on "trends in rate reductions" and not on actual productivity growth. Because rates are separated by jurisdiction, it was possible to isolate interstate results. Since then, the Commission has moved to total factor productivity ("TFP") models -- an approach that directly measures productivity growth rates.[11] Unlike the X Factor under the prior methodology, calculations based on actual productivity cannot isolate interstate results.

Finally, both petitioners argue that interstate services rely on more highly capitalized inputs than do intrastate services, and that this results in higher productivity.[12] But neither of them responds to the Commission's order, which challenges commenters to provide "empirical data" to support their argument.[13] Indeed, AT&T's own data suggest that, if it were possible to separate interstate inputs in a meaningful way, which it is not, more highly capitalized inputs would produce a ***lower*** level of productivity growth.[14]

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9 Christensen Associates, "Critique of the AT&T Performance Based Model" at 4, Attachment 6 to USTA Comments (filed Jan. 29, 1997).

10 AT&T Petition at 4.

11 ***See Price Cap Performance Review***, 10 FCC Rcd 8961, 9031 (1995).

12 Kravtin Declaration at ¶ 21; AT&T Petition at 6.

13 Fourth Report and Order at ¶ 110.

14 ***See*** Professor Frank M. Gollop, "An Economic Analysis of the AT&T and Ad Hoc Comments" at 21, filed in ***Price Cap Performance Review***, CC Dkt 94-1, as an attachment to Reply Comments of BellSouth (filed Mar. 1, 1996) ("Gollop Declaration").

II. The Commission Should Retain The Low-End Adjustment Mechanism

AT&T argues that the Commission should either eliminate the low end adjustment mechanism, or reconsider the decision to eliminate sharing.[15] The Commission should do neither.

AT&T does not seriously contest the Commission's decision to eliminate sharing, and even concedes that doing so reduces the incentives to uneconomic behavior that a sharing mechanism produces.[16] AT&T's real argument is that, in the interest of symmetry, the Commission should also eliminate the low end adjustment mechanism. But the lower formula adjustment serves a unique function unrelated to sharing.

The lower formula adjustment mechanism is intended to protect LECs from confiscatory rates without disrupting the benefits that price cap regulation provides. It is needed because of the way the Commission calculated the new X factor. Specifically, the Commission professes to base the new X factor on its own calculations of historic productivity, adjusted for differences in input prices, and augmented by a consumer productivity dividend. Thus, by the Commission's own reckoning, in order for a LEC to achieve the productivity growth implicit in the new X factor, the LEC will have to consistently beat the historic industry average. Unlike Lake Wobegon, all of the LECs cannot be above average,[17] and some LECs, despite reasonable efforts,

15 AT&T Petition at 15.

16 AT&T Petition at 14.

17 In Garrison Keillor's fictional Minnesota town of Lake Wobegon, "all the children are above average."

are likely to miss the mark. The lower formula adjustment provides a safety net to avoid a complete disruption of the price cap system.

AT&T expresses new found concern over the supposed harm to efficiency incentives caused by the lower formula adjustment. In fact, the supposed harm is essentially non-existent. In order to qualify for a lower formula adjustment, a company must suffer through a year and a half of low earnings which may never be recouped. The lower formula adjustment merely allows a one-time adjustment in the following year's rates in order to avoid back-to-back earnings below 10.25% -- not the 11.25% earnings benchmark level. In combination with the fact that dramatically increasing competition will constrain even permissible rate increases, the sum of the delays, hardships and uncertainties mean that the lower formula adjustment will have little or no impact on a company's incentives to increase efficiency and profitability.

III. Look-Back Should Not Go Beyond A Single Year

AT&T urges the Commission to inflate the size of the existing price cuts further by requiring rates to be set as if the new, higher X factor had been in effect for two years rather than one as the Commission directed. But even if the Commission had authority to require a one-year look-back, an issue that will be addressed in the pending appeal rather than here, AT&T is wrong to suggest that it could or should be extended.

While the Commission's order claims to "strike the proper balance between stockholder and ratepayer interests,"[18] AT&T would ignore one side of that balance altogether. As the Commission recognizes, the lengthy period that its "interim" price cap rules were in place would make a look-back for the entire period unreasonable. Every year of look-back undermines the

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[18] Fourth Report and Order, ¶ 179.

confidence of LECs in the continuity of current rates, and further undermines the efficiency incentives that price caps were designed to create. Reaching farther back will only serve to dampen LECs' and investors' confidence in the permanency of rates as they contemplate new investments. The Commission should reject AT&T's claim for what it is -- an attempt to garner an additional windfall at the cost of destroying much of the benefit that price caps was designed to produce.

IV. The Commission Was Correct To Reject Ad Hoc's Productivity Submissions

After evaluating Ad Hoc's productivity model, the Commission elected to give the submission all the weight it was due -- none. Ad Hoc offers no improvement to its submission, but rather argues that the Commission erred in its finding of multiple deficiencies in Ad Hoc's model. Nothing in its latest submission supports a reconsideration of the Commission's prior evaluation of Ad Hoc's model.

First, Ad Hoc claims that the Commission erred in its conclusion that the Ad Hoc model was submitted in the "proprietary format of a commercial software program."[19] Ad Hoc does not dispute that it relied on a proprietary commercial software program, but argues that the program was "advertised for sale on a regular basis in a number of well-known economic journals."[20] While that may be true, it misses the Commission's point. USTA and AT&T submitted their models on spreadsheet programs so that all the operations of the models were specified and any party could review the calculations. In contrast, many of the functions of the Ad Hoc model were not in the model itself, but were buried in the program relied on by Ad Hoc. Even if parties

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19 Ad Hoc Petition at 1, quoting (without citation) Fourth Report and Order at ¶ 38.

20 Kravtin Declaration at ¶ 8.

had purchased the underlying program, they could not readily break down and evaluate the model's operations.[21] This presented an additional obstacle to the Commission in evaluating Ad Hoc's model, straining already limited resources to address the voluminous record on productivity analysis.

Second, Ad Hoc fails to confront the Commission's technical criticisms of its base model. Ad Hoc's model relied on data from a previous filing of the USTA's TFP model. That model was significantly adjusted to address the concerns raised in the interim price cap order,[22] but Ad Hoc never made similar adjustments to its own model, claiming that the "simplified" USTA model did not change significantly from the original model.[23] While the final TFP results of the simplified model were not significantly changed from the prior USTA filing, fluctuations in annual input growth rates were reduced.[24] These changes were ignored by Ad Hoc, which fails to explain its own erratic results. Instead, Ad Hoc tries to obfuscate the issue by asserting that the Commission's criticism confused the input price index with the input price differential.[25] Ad Hoc presumes that the "intermediate results" that the Commission identified as exhibiting erratic fluctuations are the TFP and input price differential results presented in Ad Hoc's report attached

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[21] Indeed the software relied on by Ad Hoc promotes itself as a "complete language" that has "many built-in functions." ***See*** http://www.tspintl.com/tspinfo/whatis.htm.

[22] ***See Price Cap Performance Review for Local Exchange Carriers***, CC Docket No. 94-1, Comments of USTA, Attachment A, "Total Factor Productivity Methods for Local Exchange Carrier Price Plans," at ii-iv (filed Dec. 18, 1995) ("Simplified Model").

[23] ***See Price Cap Performance Review for Local Exchange Carriers***, CC Docket No. 94-1, Ad Hoc Reply Comments at 5 (filed Mar. 1, 1996).

[24] Simplified Model at v.

[25] Kravtin Declaration at ¶ 15.

to its comments. But a careful reading of the order makes it clear that the Commission is referring to the intermediate input price index results from Ad Hoc's proprietary model.[26]

Ad Hoc also complains that the Commission rejected two adjustments to its model that would have driven the X factor even higher.[27] The Commission was right to reject each of these adjustments. First, as previously discussed, Ad Hoc argues for an adjustment to reflect an interstate-only productivity factor.[28]

Second, Ad Hoc repeats its arguments for a "hedonic price adjustment" to reflect the effects of technological improvement.[29] Again, Ad Hoc misses the point of the Commission's rejection. The Commission found Ad Hoc's adjustment to be an unsupported "assumption,"[30] rather than a supported recommendation. Rather than provide such support, Ad Hoc resubmits the same summary of economic literature setting forth the unremarkable proposition that technology improvements have increased the capacity of computers.

Ad Hoc also fails to respond to record criticism that even if a hedonic adjustment were appropriate, it would have to include offsetting changes that would result in no net impact on the final X factor. In contrast, Ad Hoc proposes only a partial adjustment that is biased toward a higher X factor. Ad Hoc proposed only decreasing the input costs for the LECs, which would have the impact of increasing the input price differential, which in turn would raise the X factor.

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26 Fourth Report and Order at ¶ 38.

27 While Ad Hoc mentions a third adjustment concerning the weighting of the capital input index, it offers no argument that the Commission should reconsider its decision on that issue.

28 ***See*** Section I, ***supra***.

29 Kravtin Declaration at ¶¶ 24-27.

30 Fourth Report and Order at ¶ 67.

It did not calculate the hedonic adjustment on the economy-wide prices, which would have the opposite impact.[31] Ad Hoc also failed to calculate the impact of an hedonic adjustment on existing LEC capital. Such an adjustment would increase the growth in capital inputs, which results in lower TFP, thereby reducing the X factor.[32] As proposed, Ad Hoc's simplistic hedonic adjustment is a make-weight for a higher X factor.

V. Consideration of Multiple X Factors Should Not Be Limited To Smaller Companies

Both Cincinnati Bell and Citizens urge the Commission to adopt lower X factors for companies that cannot, for reasons outside of their control, expect to achieve the same productivity result as the industry as a whole.[33] If the Commission does consider an alternative X factor for some companies, it is not reasonable to assume that the logical beneficiaries should be smaller or rural companies.

On the contrary, the X factor is intended to measure productivity growth, not absolute levels. As a result, it is the larger firms that have the greater challenge. As Dr. Christensen has explained:

> [S]maller firms tend to be able to exploit higher returns to scale than larger firms, and thus when their output grows their unit costs will drop more rapidly than for large firms. Hence, large firms will tend to have a higher ***level*** of productivity but a lower ***rate of growth*** of productivity. It is only the ***rate of growth*** of

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31 *See* Gollop Declaration at 6-13.

32 *See* Fuss Declaration at ¶ 16, n. 10.

33 Cincinnati Bell Telephone Company Petition for Reconsideration (filed July 11, 1997); Petition for Reconsideration of Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262 Filed By Citizen's Utilities Co. (filed July 11, 1997).

productivity that is relevant for choosing the break-even offset in the price cap formula.[34]

Conclusion

For the foregoing reasons, the Commission should deny the petitions for reconsideration.

Respectfully submitted,

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August 18, 1997

[34] Statement of Dr. Laurits R. Christensen, "Productivity Adjustment in the Price Cap Proposal" at 8, filed in ***Policies and Rules Concerning Rates for Dominant Carriers***, CC Dkt. No. 87-313, as Attachment B to AT&T's Reply Comments on the Further Notice of Proposed Rulemaking (filed Sept. 9, 1988).

CERTIFICATE OF SERVICE

I hereby certify that on this 18th day of August, 1997, a copy of the foregoing "Opposition of Bell Atlantic to Petitions for Reconsideration" was served by first class U.S. mail to the parties on the attached list.

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